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Legal Update

Could the US Government's Financial Stability Oversight Council Subject the Residential Mortgage Industry or Mortgage REITs to Supervision by the Federal Reserve and Prudential Standards?

Raise your hand if you are an independent mortgage banker, a residential mortgage real estate investment trust ("mREIT") or a non-bank investor in residential mortgage loans that would like to be subject to additional federal government supervision of your entire operations, not just the nuts and bolts of your mortgage lending, servicing or whole loan purchase business. Raise both hands if you also would like to be subject to prudential standards. And, in either case, you would not be entitled to any of the substantive benefits of being a federally-chartered bank. I suspect that no one raised either hand and that is not surprising given the level of federal and state regulation of the residential mortgage business.

Chicken Little was not necessarily right, the regulatory sky is not necessarily falling, but you should be aware of the December 4, 2019, issuance by the Financial Stability Oversight Council (the "Council") of its "Final Interpretive Guidance" regarding its authority to require supervision and regulation of certain nonbank financial companies and subject such companies to prudential standards (the "Guidance"). Replacing earlier guidance that the Council issued in 2012, the Guidance describes the processes the Council intends to follow if it were to consider making a determination to subject a nonbank financial company to supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and prudential standards.

Many of Mayer Brown's nonbank financial company clients, including mREITs, have asked us to provide our thoughts on the risk that nonbank residential mortgage lenders, servicers and purchasers might be subject to such enhanced regulatory scrutiny and prudential standards by the Council or increased state and federal regulation to head off action by the Council. The purpose of this Legal Update is to give a broad overview of this newly revised evaluative process, not to predict what may happen in the future.

Background

Whether to protect taxpayers, consumers or investors, there is no shortage of substantive laws and regulations designed to prevent wrongdoing and harm or of governmental agencies and instrumentalities to enforce those laws and regulations and, in some cases, supervise and examine market participants. Think, for example, of federal banking agencies, like the Office of Comptroller of the Currency ("OCC"), or the Securities Exchange Commission ("SEC") and state equivalents, or state licensing authorities like the New York Department of Financial Services, state insurance commissioners, or the Consumer Financial Protection Bureau ("CFPB").

In each case, there is a governing statute that (1) creates the governmental authority for a particular public purpose, (2) imposes substantive prohibitions or requirements or delegates rule-making authority to the related government authority to promulgate such substantive prohibitions or requirements pursuant to notice and comment rule-making, (3) empowers the government authority to supervise and examine industry participants that engage in the activity that is the subject of the law for legal and regulatory compliance and (4) authorizes government enforcement actions for non-compliance. Sometimes the supervision, examination and related enforcement processes apply only if the industry participant is approved to participate in a government program, such as residential mortgages that are insured or guaranteed by the Federal Housing Administration or the Department of Veterans Affairs and perhaps pooled to back securities guaranteed by the Government National Mortgage Association ("Ginnie Mae").

While such authority to supervise and examine relevant industry participants typically is explicitly provided in the enabling statute, sometimes the statute provides mere discretionary authority to subject a new class of industry participants to governmental supervision and examination upon a finding of need. Note, for example, the CFPB has express supervisory authority over all nonbank covered persons offering or providing residential mortgage loans, private education loans and payday loans. Its supervisory authority with respect to other consumer asset classes is more muted. The CFPB may assert supervisory jurisdiction over "larger participant[s] of a market for other consumer financial products or services," as the CFPB defines by rule, based on its determination that such supervision is necessary and appropriate to enable the CFPB to administer and carry out the purposes and objectives of federal consumer financial law. For example, it has used this authority to supervise credit reporting agencies, debt collection agencies and auto lenders. This elastic jurisdictional authority gives the CFPB the flexibility to react to problems it subsequently discerns by granting itself supervisory authority over industry participants.

While many industry participants are critical of over-regulation and the sometimes strict hands of provident regulators, occasionally the government does not act fast enough to seek to prevent major harm. This can be and has been true in some cases where there was a governmental entity that had authority to intervene but either did too little too late or not at all, on the one hand, and where there was not even an applicable governmental entity to address the issue in any systematic way, on the other hand. Nevertheless, few regulated industry participants voluntarily will call for themselves to be subject to greater regulatory oversight, although they may wish that their competitors whom they perceive to play "fast and loose" should be so subject. And likely even fewer non-regulated industry participants will lobby to be subject to governmental supervision and regulation, except in cases where they see their industry being eaten away by bad actors and regard governmental intervention as a matter of industry survival.

Forget the philosophical debates over the need for more or less government regulation;

following the financial crisis from approximately 2008-2010, the public policy question was not whether to increase government oversight of financial industry participants, but how. Enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") answered the "how" question. It did so in approximately 2,300 pages of substantive provisions and by authorizing many more thousand pages of regulations to implement those provisions.

An underlying premise permeates the Dodd-Frank Act—namely, that unregulated or under-regulated nonbank financial companies from time to time may pose material risks to the broader US financial system and the federal government may have insufficient tools to reign in and manage that risk until it is too late. To address this concern in part, Section 111 of the Dodd-Frank Act established the Council in order to identify risks to US financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies; promote market discipline; and respond to emerging threats to the stability of the US financial system. The Dodd-Frank Act designed the Council to facilitate a holistic, integrated approach among various federal agencies to manage the potential material risk of nonbank financial companies. In this regard, the voting members of the Council are the Secretary of the Treasury, who shall serve as Chairperson of the Council; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; the Director of the CFPB; the Chairman of the SEC; the Chairperson of the Federal Deposit Insurance Corporation; the Chairman of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Board; and an independent member appointed by the President, with the advice and consent of the Senate, having insurance expertise.

Among other statutory authorities, the Council may seek to accomplish these statutory purposes by requiring supervision by the Federal Reserve for nonbank financial companies that may pose risks to US financial stability. In making a determination that a nonbank financial company should be subject to such supervision, the Council is obligated under to the Dodd-Frank Act to consider:

- The extent of the leverage of the company;
- The extent and nature of the off-balance-sheet exposures of the company;
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, businesses and state and local governments and as a source of liquidity for the United States financial system;
- The importance of the company as a source of credit for low-income, minority or underserved communities and the impact that the failure of such company would have on the availability of credit in such communities;
- The extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness and mix of the activities of the company;
- The degree to which the company is already regulated by one or more primary financial regulatory agencies;
- The amount and nature of the financial assets of the company;

- The amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the Council deems appropriate.

In implementing this statutory mandate, the Council first established guidance and procedures pursuant to which it would determine whether and how to exercise the statutory authorities on which it relied in designating a large insurance company as a "Systemically Important Financial Institution" (a "SIFI")—a determination that the insurance company ultimately successfully challenged in court. This new Guidance represents a "back to the drawing board" approach by the Council.

Summary Description of the Guidance

In a nutshell, the Council intended the new Guidance "…to enhance the Council's transparency, analytical rigor, and public engagement." This is another way of highlighting the prior criticism of the Council's designation process as being opaque, analytically loose and insulated from public scrutiny.

In a major change from the prior guidance, the Council will start with *an activities-based approach*, instead of *an entity-based approach*, to seek to identify, assess and address potential risks and threats to US financial stability. The Guidance clarifies that this change in approach is consistent with the Council's priorities of identifying and assessing potential risks and emerging threats on a system-wide basis and thus reducing the potential for competitive market distortions that might arise if instead its first focus were on individual entities. In utilizing an activities-based approach, the Council intends to examine a diverse range of financial products, activities and practices that could pose risk to US financial stability, in part by considering linkages across products, activities and practices and their interconnectedness across firms and markets. Nevertheless, the Council reserves the ability to make an entity-specific determination but only if a potential risk or threat cannot be adequately addressed through an activities-based approach.

The Council identified four framing questions on which its analysis of any identified risk will focus:

1. How could the potential risk be triggered? For example, could it be triggered by sharp reductions in the valuation of particular classes of financial assets?
2. How could the adverse effects of the potential risk be transmitted to financial markets or market participants? For example, what are the direct or indirect exposures in financial markets to the potential risk?
3. What impact could the potential risk have on the financial system? For example, what could be the scale of its adverse effects on other companies and markets, and would its effects be concentrated or distributed broadly among market participants? This analysis should take into account factors such as existing regulatory requirements or market practices that mitigate potential risks.
4. Could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the US economy?

After identifying and assessing such potential system-wide risks, the Council, in turn, will try to work with the relevant financial regulatory agencies at the federal and state levels to seek to implement a method to mitigate risk to financial stability. This emphasis on collaboration is predicated on the notion that the relevant financial regulatory agencies generally possess greater information and expertise with respect to company, market and product risks, perhaps putting them in a better position to address potential risks, and at the same time not subjecting the companies to new regulatory authorities.

If existing regulators take appropriate actions, such as modifying their regulation or supervision of companies or markets under their jurisdiction in order to mitigate potential risks to US financial stability identified by the Council, the Council would not need to intervene more directly. The Guidance suggests that appropriate actions that existing regulators could take include restricting or prohibiting the offering of the risky product or requiring market participants to take additional risk-management steps that address the risks.

But if the Council believes the regulators' actions to be inadequate, it has the authority to make formal public, but non-binding, recommendations to the regulators. The Council is required under the Guidance to conduct a cost-benefit analysis prior to making a final recommendation to the regulators, unless the regulators themselves conducted such an analysis. Only if the expected benefits to financial stability resulting from the determination justify the expected costs that the determination would impose may the Council make the final recommendation. During this evaluative phase, the Council is required to engage with companies and their existing regulators to provide greater visibility into the perceived risk factors and greater opportunity for the companies and their regulators to provide timely relevant information. The Council may elect to report to Congress on recommendations for legislation that would prevent identified activities or practices from threatening US financial stability if there does not exist sufficient regulatory oversight of the markets or companies conducting financial activities or practices identified by the Council as posing risks.

The Guidance defines a "risk to financial stability" as the risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy. Interestingly, while not focusing on broader US financial stability, Ginnie Mae, Fannie Mae and Freddie Mac have increased their scrutiny of the financial stability of their respective mortgage servicers, with particular focus on their net worth, liquidity and capital to satisfy their obligations under the respective home finance programs. Ginnie Mae's imposition of stress tests on its "issuers" in the last year is a good example of this.

But all of these agency initiatives principally are designed to minimize the risk of program losses caused by individual issuers. While it is theoretically possible that the significantly large program losses attributable to one or more approved participants could have a "spill-over" effect on the broader economy, that is not the primary focus of these agencies. While they may have a fulsome sense of company, market and products risks that may better inform the Council's evaluation process, none of these agencies is a prudential regulator of the nonbank financial company itself, and the agencies are instead focused on eligibility to participate in their housing finance programs.

In light of this reliance on existing regulatory authorities, the Council indicated in the Guidance that only in rare instances does it anticipate that it would consider a nonbank financial company for a potential determination, such as if the products, activities or practices of a company that pose a potential threat to US financial stability are outside the jurisdiction or authority of financial regulatory agencies. In those rare cases, the Council may determine that a nonbank financial company will be supervised by the Federal Reserve and be subject to prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States or (2) the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States. In this regard, according to the Guidance, the Council intends to interpret the term "material financial distress" as a nonbank financial company being in imminent danger of insolvency or defaulting on its financial obligations. Any such determination by the Council requires both (1) an affirmative vote of at least two-thirds of the voting members of the Council then serving, including an affirmative vote by the Secretary of the Treasury, as the Chairperson of the Council, and (2) the satisfaction of lengthy process to afford a nonbank financial company the opportunity to challenge a proposed determination by the Council.

In order to make a determination of whether one of the two standards is met, the Council will analyze the 10 specific considerations mandated by the Dodd-Frank Act and any other risk-related factors that the Council deems appropriate. The Guidance says that the Council will emphasize three particular analyses resulting from its review of the considerations.

First is whether the creditors, counterparties, investors or other market participants of a nonbank financial company have significant enough direct or indirect exposure to the nonbank financial company to materially and adversely affect those or other creditors, counterparties, investors or other market participants and thereby pose a threat to US financial stability. In other words, is the financial equivalent of a pandemic flu a likely result of the material financial distress of a nonbank financial company?

Second is whether a nonbank financial company could pose a threat to US financial stability if it liquidated quickly assets that it holds by, for example, causing a decline in asset prices that significantly disrupts trading or funding in key markets or causes significant losses or funding problems for other firms with similar holdings.

Last is whether a nonbank financial company might become unable or unwilling to provide a critical function or service that is relied on by market participants and for which there are no ready substitutes and, as a result, poses a threat to US financial stability. A final determination by the Council is not really final, as it is required to reevaluate the determination annually. If a designated company adequately addresses the potential risks identified by the Council at the time of the final determination and in subsequent reevaluations, the Guidance provides that the Council should generally be expected to rescind its determination.

Attention to Nonbank Mortgage Originators and Servicers

In its 2019 Annual Report (the "Report") issued last December, the Council highlighted the need for continued coordination among federal and state regulators in order to collect data, identify risks and strengthen oversight of nonbank financial companies involved in the origination and servicing of residential mortgages. Underlying this concern is the observation that the share of residential mortgages originated and serviced by nonbanks has increased significantly over the past decade. Among the 25 largest residential mortgage originators and servicers, according to the Report, based on data from Inside Mortgage Finance, nonbanks currently originate approximately 51 percent of residential mortgages and service approximately 47 percent, up from just 10 percent and 6 percent in 2009, respectively. Nonbanks are particularly heavily involved in the origination of mortgages that are securitized by Ginnie Mae, Fannie Mae and Freddie Mac, notes the Report, accounting for 85 percent of Ginnie Mae MBS, 60 percent of Fannie Mae MBS and 53 percent of Freddie Mac MBS in 2019. As with originations, nonbank servicers have a larger market share for Ginnie Mae than for Fannie Mae and Freddie Mac.

The Report highlights the liquidity issues faced by most nonbank mortgage originators and servicers, as they do not have a stable funding base, heavily relying instead on short-term funding for both originations and servicing advances. This short-term funding generally consists of warehouse and servicing advance lines provided by banks for liquidity. The Report raises the issue of whether the nonbanks' lines may be at risk of cancellation in times of significant stress. It also questions whether nonbanks would be able to perform during a downturn in the housing or mortgage markets and absorb adverse economic shocks because of their relatively limited resources and capital and high debt burden.

Of course, the issue is not whether any particular industry or industry players could fail but instead what impact such a failure might have on the broader US financial system. The Report sees the fragilities noted above as potentially causing the nonbank sector to be a source of weakness if there is a contraction in the largest nonbanks' ability to originate and service mortgages. This perceived weakness, according to the Report, may transmit risk to the broader financial system through several channels:

> Nonbanks are significant counterparties to the FHA, to Ginnie Mae, and to the Enterprises [i.e., Fannie Mae and Freddie Mac]. If delinquency rates rise or nonbanks otherwise experience solvency or liquidity strains, Ginnie Mae and the Enterprises could experience losses and operational challenges associated with transferring servicing to a financially sound servicer, especially the servicing of delinquent mortgages. The FHA and the Enterprises may also have difficulty enforcing contractual provisions that require nonbank originators to remedy defective loans. With their lines of credit to nonbanks, banks are also exposed to losses should a nonbank fail, though the exposures are somewhat limited in size and are generally well-secured by collateral.
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> Nonbanks could also transmit risk through contagion. During a period of significant market stress, strains in one nonbank could cause counterparties to question the viability of others. This could cause stress to spread among market participants. Broader contagion could lead to dislocation in the housing and mortgage markets during periods of stress.
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> Nonbanks are important providers of mortgage credit and mortgage servicing. It is unclear whether substitutes would be available if the largest nonbanks experienced stress or widespread failure during a market downturn. Nonbanks are disproportionately large players in key market segments, such as FHA lending, which is often used by low-income, minority, and first-time homebuyer segments. Should nonbanks not be able to extend credit, these market segments could potentially experience significant changes in the terms of available loans. Banks may also be reluctant to step in to assume servicing from a failing nonbank servicer, creating significant challenges if multiple nonbank servicers simultaneously experienced financial stress.

The Report does not call for any substantive measures to mitigate these risks, other than continued cooperation among federal and state regulators to share data, monitor the risk and strengthen oversight.

Conclusion

I'll leave it to others to evaluate how likely it is that either the residential mortgage banking industry or any independent mortgage banker or mREIT would present the risk profile inviting enough scrutiny by the Council to be subjected to supervision by the Federal Reserve and prudential standards. As detailed above, the federal government would face a high hurdle if it were to seek to subject an independent mortgage banker or mREIT to Federal Reserve supervision and prudential standards. As the Report demonstrates, however, originating and servicing residential mortgage loans by nonbank mortgage originators and servicers are on the Council's radar.

For more information about the topics raised in this Legal Update, please contact.

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